No. 82-1526

IN THE

Supreme Court of the United States

October Term, 1982

INGREDIENT TECHNOLOGY CORPORATION,
formerly known as SuCrest Corporation,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Questions Presented

1. Did the Court of Appeals erroneously uphold a criminal conviction based on an unprecedented and unforeseeable interpretation of the Internal Revenue Code, as to which petitioner did not have fair notice, in violation of the due process clause of the fifth amendment to the Constitution of the United States?

2. Did the Court of Appeals err in judging the issue of fair notice under a subjective standard, rather than under the objective standard of whether the law was clear to a reasonable person, in conflict with decisions of this Court and of other federal courts of appeals?

Parties

The parties to this proceeding are Ingredient Technology Corporation, formerly known as SuCrest Corporation, petitioner, and the United States of America, respondent.* Robert M. Rapaport, who was also a party to this action in the United States Court of Appeals for the Second Circuit, has filed a separate petition for a writ of certiorari.

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* Ingretec, S.A. is a subsidiary of Ingredient Technology Corporation.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

PAGE

Cases:

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Ingredient Technology Corporation respectfully requests that a writ of certiorari issue to review the opinion and judgment of the United States Court of Appeals for the Second Circuit, entered on January 5, 1983.

Opinion Below

The opinion of the United States Court of Appeals for the Second Circuit has not yet been reported. It is reproduced herein at A1-A26.*

The United States District Court for the Southern District of New York issued no opinion on the issue raised by this petition.

Jurisdiction

The decision of the United States Court of Appeals for the Second Circuit was entered on January 5, 1983. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

Constitutional and Statutory Provisions

The Fifth Amendment to the Constitution of the United States provides, in relevant part, that "[n]o person shall be . . . deprived of life, liberty, or property, without due process of law. . . ."

The following statutes and regulations are reproduced in the Appendix: 18 U.S.C. § 371, 26 U.S.C. § 7201, 26 U.S.C. § 7206, 26 U.S.C. § 471, 26 U.S.C. § 472, and 26 C.F.R. § 1.471-1.

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* References preceded by "A" are to the Appendix to this petition; "Tr." refers to the trial transcript; "ITC Br." refers to Ingredient Technology Corp.'s brief in the Court of Appeals; and "R.Cert.Pet." refers to the Petition for a Writ of Certiorari filed in this Court by co-petitioner Robert M. Rapaport.

Statement of the Case

A. Introduction

This Court should review the decision of the Court of Appeals which violates the Constitutional standards previously established by this Court, conflicts with decisions of other courts of appeals, and creates an unjust and unconstitutional rule which will adversely affect the administration of federal tax and criminal laws.

The Court of Appeals adopted a novel and totally unprecedented interpretation of the provisions of the Internal Revenue Code relating to inventories and then upheld a *criminal* conviction based on petitioner's having failed to foresee that this gloss would be added to the statute. In conflict with settled law in other Circuits, under which criminal liability may attach only to conduct which a reasonable person could have known was proscribed, the court below held that this retroactive expansion of criminal liability did not violate the due process clause because evidence in the record could have supported a finding that employees of the corporation subjectively believed their conduct to be unlawful. This decision is not only in conflict with rulings of other federal courts of appeals, but also so far departs from previously settled principles of Constitutional law and federal tax policy as to call for an exercise of this Court's power of supervision. Supreme Court Rule 17.1 (a).

B. Background

Petitioner Ingredient Technology Corporation, formerly known as SuCrest Corporation ("SuCrest"), was, during the period of time in question, a publicly-held company

which was engaged in the business of buying, selling and refining sugar. The Government charged that SuCrest and its then President, Robert M. Rapaport,* engaged in a scheme to evade SuCrest's corporate taxes by the improper inclusion of certain sugar purchases in its inventory, as follows.

Due to dramatic increases in the price of domestic raw sugar in 1974, SuCrest shifted, on the recommendation of accountants, from a FIFO ("First In First Out") to LIFO ("Last In First Out") inventory accounting method. Under the LIFO method, inventories are valued at the price of the earliest purchases, and the cost of goods sold is valued at the price of the latest purchases (Tr. 514). In this way, the LIFO method matches current costs against current revenues (Tr. 671, 672-673).

Toward the end of its fiscal year 1975, SuCrest discovered that its inventory of sugar had fallen to historically low levels. Since this was a period of rapid inflation in sugar prices, the low inventory level meant that the company would "invade" its LIFO inventory base, and measure its revenues against the cost basis of "old" (and therefore cheap) sugar, instead of against "current" (and therefore relatively expensive) sugar.** Recognition of profit on this distorted basis would have artificially exag-

* Mr. Rapaport has filed a separate Petition for a Writ of Certiorari in this Court. Also indicted with SuCrest and Mr. Rapaport was Allerton D. Marshall, the Treasurer of SuCrest. He was acquitted at trial.

** The essence of both FIFO and LIFO inventory theories, of course, is that both are equally fictional; in neither instance does the priority in which the commodity is used to calculate cost of goods sold follow the actual movement of real sugar (Tr. 1540, 1609-10, 1988).

gerated the profits, and therefore the taxes, of SuCrest, defeating the purpose of the LIFO election.

C. The 1975 Transaction

In order to postpone the recognition of profits thus generated, SuCrest adopted the following procedure: Shortly before the end of its fiscal year, SuCrest entered into a written agreement with one of its suppliers, Czarnikow-Rionda Co. ("Rionda"), to purchase sufficient quantities of sugar to buffer its LIFO base. Simultaneously with this agreement, the parties reached an oral understanding that early in the 1976 fiscal year Rionda would repurchase a similar amount of sugar based upon market prices at that time. At the time of the original purchase, both Rionda and SuCrest entered into opposite transactions on the futures exchange, thus "hedging" their purchases.*

Before the end of the fiscal year 1975, Rionda declared to SuCrest the sugar cargoes of two ships, thereby passing

* A virtually identical result could have been achieved, in a manner that the Government apparently concedes to be beyond reproach, if SuCrest had purchased the Rionda sugar and simultaneously sold the same amount of sugar short on the New York Coffee and Sugar Exchange ("the Exchange") for delivery after the end of the fiscal year—a traditional "hedge." The shortcoming of such a hedge, however, was that the price of actual sugar is a CIF ("cost, insurance and freight") quotation, while prices on the Exchange are FOB ("free on board") prices. The difference between these prices—the so-called "CIF differential"—varies widely and is itself subject to market fluctuation; SuCrest had recently lost approximately $2.5 million, in a period of a few months, because of fluctuations in the CIF differential (Tr. 703, 1663). The "double hedge" accomplished through Rionda, in essence allowed SuCrest to hedge both the purchase of the Rionda sugar and the CIF differential. Such a contract does exist on the Exchange, but could not be accomplished as a practical matter on the Exchange because the market was too thin, *i.e.*, there were too few buyers and sellers trading in sugar at a CIF price to permit trading in substantial quantities of sugar (Tr. 256-57, 1219, 1393).

title and risk of loss of the sugar to SuCrest in accordance with the terms of the written contract (Tr. 865-866, 1297). When SuCrest filed its tax return for 1975, it calculated its profits on the basis of having included these Rionda purchases in inventory.

D. The 1976 Transaction

Toward the end of its 1976 fiscal year, SuCrest and Rionda engaged in a similar series of transactions. Once again, Rionda sold and declared to SuCrest a large quantity of sugar at the end of the fiscal year, and in the early weeks of the new fiscal year SuCrest sold to Rionda a corresponding amount of sugar, by prior arrangement. With respect to its 1976 corporate tax returns, however, SuCrest did not include the Rionda purchases in its inventory. This change in tax treatment was the result of an internal investigation conducted at SuCrest's request by the New York law firm of Milbank, Tweed, Hadley & McCloy. After a lengthy investigation that included the taking of sworn testimony, tne Milbank firm issued a report concluding that the Rionda sugar should not be included in SuCrest's inventory for tax purposes, but observed that its conclusion was "not free from dispute, and reasonable persons expert in the fields of tax law and accountancy may differ in their interpretations and conclusions." Quoted in I.T.C. Br. at 20.

The net result of the 1975 Rionda transactions—and the contemplated result of the 1976 transactions as well—was the postponement of corporate taxes. The temporary addition of the Rionda sugar to inventory did not eliminate the ultimate need to recognize profits calculated on the basis of the "old" (and thus inexpensive) sugar; it merely

postponed such recognition into a later year. As a matter of logic, profit based on the inventory would eventually have to be recognized. In fact, SuCrest recognized such profits, and thus paid every penny of taxes that it was alleged to have "evaded" in 1975, when it closed out its sugar inventory in a subsequent year.

As set forth at pp. 11-14 below, the tax issue whether SuCrest could include the Rionda purchases in inventory had never, prior to this case, been litigated in any civil or criminal proceeding, nor was it addressed by any tax regulation or ruling until 1979, several years *after* the events in question, when the Internal Revenue Service adopted Rev. Rul. 79-188, which dealt with the issue for the first time. (*See* discussion *infra* at pp. 14-15). The use of commodity transactions for the sole purpose of postponing the recognition of profit, of course, is not new, and has been expressly tolerated by the Internal Revenue Service. *See* discussion in R.Cert.Pet. at 6-7.

E. The Rulings of the Courts Below

SuCrest was indicted on August 27, 1981, and charged with multiple counts redundantly charging income tax violations for 1975 and 1976 as follows: (1) conspiracy to evade Federal corporate income taxes for the fiscal year ended May 31, 1975, in violation of 18 U.S.C. § 371 (Count 1); (2) willful attempt to evade Federal corporate income taxes for the fiscal year ended May 31, 1975, in violation of 26 U.S.C. § 7201 (Count 2); (3) willfully making and subscribing a false Federal corporate income tax return for the fiscal year ended May 31, 1975, in violation of 26 U.S.C. § 7206(1) (Count 4); and (4) conspiracy to defraud

the United States with respect to the fiscal year ended May 29, 1976, in violation of 18 U.S.C. § 371 (Count 3). Messrs. Rapaport and Marshall also were charged in Counts 1, 2 and 3, and with willfully aiding and assisting the preparation of a false Federal corporate income tax return for the fiscal year ended May 31, 1975, in violation of 26 U.S.C. § 7206(2) (Count 5).

Beginning on December 28, 1981, SuCrest and the individual defendants were tried before the Honorable Robert L. Carter, United States District Judge for the Southern District of New York, and a jury. At the close of the Government's case, SuCrest moved for judgment of acquittal on the ground that as a matter of law, the Rionda sugar was includible in closing inventory because SuCrest had valid title and risk of loss before the end of its fiscal year (Tr. 1805). In the alternative, SuCrest moved for acquittal on the ground that the applicable tax law governing the question of inventory accounting in this case was unresolved or unclear and therefore criminal liability cannot be imposed (Tr. 1817). The District Judge conceded that SuCrest's position on including the Rionda sugar in inventory "might be entirely correct . . . if this were a civil proceeding" (Tr. 1815). However, the Judge felt that in a criminal tax case the only issue was intent (Tr. 1813). On this reasoning, the Court below denied the motion for judgment of acquittal (Tr. 1854).

SuCrest introduced the expert testimony of William Badecker, a Certified Public Accountant and a member of the firm of Main Hurdman, the third largest accounting firm in the world (Tr. 2027). Mr. Badecker has written and lectured extensively on numerous accounting subjects,

including LIFO accounting (Tr. 2027-2029). Mr. Badecker testified that in his opinion, the Rionda sugar was properly includible in SuCrest's closing inventory because SuCrest had title and risk of loss with respect to the sugar (Tr. 2033-2035). Under generally accepted accounting principles, these elements gave the transaction sufficient "substance" to permit SuCrest to include the sugar in inventory (Tr. 2050-2051). Mr. Badecker testified that the existence of an oral agreement between SuCrest and Rionda to re-sell the sugar did not alter his conclusion, because title and risk of loss passed to SuCrest before the end of its fiscal year regardless of the oral resale agreement (Tr. 2052).

SuCrest also proffered testimony of two experts in the field of United States corporate income taxation: Richard B. Stone, Professor of Law at Columbia University and formerly the attorney in the office of the Solicitor General of the United States in charge of all tax cases before this Court; and David P. Taylor, an attorney and CPA who has written and lectured on LIFO accounting and is the Director of Taxation for the Clark Equipment Co. (Tr. 1875-1878, 1885-1894). Professor Stone and Mr. Taylor would have testified that in their opinion, well-established principles of tax law and inventory accounting permitted SuCrest to include the Rionda sugar in its inventory, regardless of the existence of an oral resale agreement (Tr. 1910-1922). This conclusion was based on the fact that SuCrest had title and a risk of economic and physical loss (Tr. 1911-1914, 1919-1922). Professor Stone would have further testified that the Internal Revenue Code and regulations in force at the time of these transactions permitted the inclusion of the sugar in inventory, and that SuCrest

could not have predicted at that time the courts would reach a different conclusion (Tr. 1916-1918).

The testimony of Prof. Stone and Mr. Taylor was excluded by the District Court, a ruling which is challenged in co-defendant Robert Rapaport's petition for a writ of certiorari in this Court.

On January 20, 1982, the jury found Mr. Marshall not guilty on all counts, found SuCrest guilty on Counts 1, 3 and 4, and found Mr. Rapaport guilty on Counts 1, 3 and 5. The jury announced that it was deadlocked as to SuCrest and Mr. Rapaport on Count 2 (tax evasion). A mistrial was declared as to Count 2 over SuCrest's objection (Tr. 2516).

On April 16, 1982, SuCrest was sentenced to the maximum fine of $10,000 on Count 1, $10,000 on Count 3 and $5,000 on Count 4, plus the costs of the prosecution. On January 5, 1983, the United States Court of Appeals for the Second Circuit affirmed the conviction (A1-A26). That court rejected SuCrest's argument that the sugar was includible in inventory (A10-A16). It also rejected SuCrest's fair notice argument; while the court never held that the law was clear, it stated that "[h]ere surely the defendants knew they were committing a wrongful act" (A18), based on the concealment of the resale agreement and the fact that officers of SuCrest had lied to the company's auditors and attorneys. *Id.*

Reasons for Granting the Writ

I.

SuCrest's Conviction Was Based on an Unforeseeable Interpretation of the Internal Revenue Code, Depriving It of Its Right to Fair Notice.

A. The Interpretation of the Internal Revenue Code by the District Court and the Court of Appeals Was Not Foreseeable.

Prior to this prosecution, *no* case, civil or criminal, had dealt with the propriety of including in inventory goods subject to a resale agreement. As noted below, SuCrest literally satisfied all of the terms of the governing regulation. The Government's argument, that the court should read into the statute a vague requirement of "substance over form", was based solely on analogies to other areas of tax law; SuCrest's position had support in prior law that was at least as strong. *See* I.T.C. Br. at 24-34; *see also* p. 14, *infra*. Experts in the field of federal tax law and accounting testified in the trial court, without contradiction by the Government, that SuCrest's position was correct and that the law was at worst unclear. (*See* pp. 8-10, *supra*). Under these circumstances, the decision below affirming SuCrest's conviction violates the fundamental requirement of fair notice.

Section 471 of the Internal Revenue Code provides that inventories shall be kept "on such basis as the Secretary may provide." Section 472 specifically authorizes the use of the LIFO method of inventory. The governing regulation, 26 C.F.R. § 1.471-1, provides in relevant part that "inventory should include all . . . raw materials . . . which

have been acquired for sale . . . if title thereto is vested. . . ." The regulation make clear that "[a] purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession. . . ." *Id.* (These statutes and regulations are reproduced in full at A29-A32.)

The sugar that SuCrest purchased from Rionda clearly met all of these requirements. The Court of Appeals, however, accepted the Government's argument that SuCrest could not include this sugar in inventory because the transaction did not involve any "beneficial interest other than the reduction of taxes" (A14), and was thus a "sham" (A8). This interpretation of IRC § 471 is supported by *no* prior decision of *any* court construing that statute or the regulations thereunder. SuCrest had literally complied with every formal requirement of the applicable statute and regulations; for the Court of Appeals to read into the statute a "business purpose" requirement, while perhaps arguable in a *civil* tax proceeding,* is the sort of retroactive expansion of criminal liability that has long been condemned by this Court as violative of the due process clause. *See* 15-16, *infra*. As one commentator has noted:

> In spite of all that has been written about the business purpose doctrine, sham transactions, net effect, and

* SuCrest contended in the District Court and the Court of Appeals that, even as a matter of civil tax law, the sugar was properly includible in inventory. While this issue is not raised in this Court, the presence of a good faith dispute as to this issue points out the lack of clarity of the law at the time of the events in issue.

Additionally, it should be noted that in *William Powell Co.* v. *United States*, 524 F.Supp. 841 (S.D. Ohio 1981), a *civil* tax case involving LIFO inventories, the court declined to read a "business purpose" test into the LIFO rules. 524 F.Supp. at 846 n.5.

the role of the court in looking through form to find substance, no authoritative, explicit rationale for judicial intervention to frustrate plans for tax avoidance has ever been given. The unpleasant conclusion remains that predicting the outcome of a concrete case in many of these areas, after a flood of decisions, remains often difficult and sometimes impossible.

Fuller, *Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation*, 37 Tul. L. Rev. 353, 389 (1963). *See also* Panel, *Substance vs. Form in Corporate Activities*, 20 N.Y.U. Inst. on Fed. Tax. 975, 1080 (1962).

Where no court had ever before read the requirements of a "business purpose" or "substance over form" into IRC § 471, SuCrest should not have been required, at the peril of criminal liability, to predict the result that was reached by the Second Circuit. The doctrines of "business purpose" and "sham transactions" are not universal principles of federal tax law. While they have been applied to certain areas of the Internal Revenue Code, where this is necessary to avoid frustrating the purpose of the statute,* there are numerous other areas where, as here, the statutory policy would be frustrated by failing to give effect to the form of a transaction. In such cases, the courts have required only literal compliance with the formal requirements of the Code. *See* Schaffer, *Another Guideline to the Role of Form in Corporate Transactions*, 56 Taxes 160, 161-62 (1978) (collecting cases).**

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* *See, e.g., Knetsch* v. *United States*, 364 U.S. 361 (1960) (interest deduction on sham indebtedness).

** *See also, e.g., Barber-Greene Americas, Inc.*, 35 T.C. 356, 384-90 (1960) (foreign source income); *Rushing* v. *Comm'r*, 441 F.2d 593, 598 (5th Cir. 1971) (installment sales); *Chamberlin* v. *Comm'r*, 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1954) (preferred stock bailouts; rule later changed by IRC § 306).

Thus, while the Government's argument, accepted by the courts below, is premised upon vague "substance over form" principles, the courts have frequently regarded the passage of title as the crucial event for tax purposes, rather than the "substance" of the transaction. For example, in determining the source of income of a Western Hemisphere trading corporation, courts look solely to the place where formal title passed, and not to the place where the "substance" of the sale occurred. *E.g., Barber-Greene Americas, Inc.*, 35 T.C. 365, 384-387 (1960). This is true even if the place where title passed was specifically arranged so as to achieve tax benefits. *Id.* at 386. Since LIFO is a purely theoretical method of accounting for inventory (*see* p. 4 n.**, *supra*), the purpose of the statute would not be served by reading into it a requirement of "substance over form" or "business purpose".

That the substantive theory of tax law relied upon by the Court of Appeals was not settled at the time of transactions in issue is made clear by the fact that in 1979 (four years *after* the events at issue in this case) the I.R.S. for the first time issued a Revenue Ruling supporting this theory. Rev. Rul. 79-188, 1979-1 C.B. 191, stated for the first time that it was the I.R.S.' position that a manufacturer which made year-end purchases to avoid invasion of its LIFO base could include those goods in its LIFO inventory only if they were intended to be used in the ordinary course of business. The very fact that a Revenue Ruling was issued on this point in 1979 establishes that the law was unclear in 1975 and 1976, the years when Su-Crest did the acts which are the basis of this conviction. The governing regulation provides that Revenue Rulings will be published only when they involve issues not "an-

swered by statute, treaty or regulations" or "by ruling, opinions or court decisions previously published in the [Internal Revenue] Bulletin," 26 C.F.R. § 601.601 (d)(2)(iii). *See also* Rev. Proc. 78-24, 1978-2 C.B. 503.

B. An Unforeseeable Expansion of Criminal Tax Liability Violates the Due Process Clause.

This Court has long held that the due process clause of the fifth amendment requires that any criminal statute "give a person of ordinary intelligence fair notice that his contemplated conduct is forbidden by the statute. The underlying principle is that no man shall be held criminally liable for conduct which he could not reasonably understand to be proscribed." *United States* v. *Harris*, 347 U.S. 612, 617 (1954).* This principle is not limited to facially vague statutes; rather, whenever "an unforeseeable . . . construction of a criminal statute is applied retroactively to subject a person to criminal liability for past conduct, the effect is to deprive him of due process of law in the sense of fair warning that his contemplated conduct constitutes a crime." *Douglas* v. *Buder*, 412 U.S. 430, 432 (1973), *quoting Bouie* v. *City of Columbia*, 378 U.S. 347, 354-55 (1964). *Accord, Marks* v. *United States*, 430 U.S. 188, 191-95 (1977).

This rule applies with particular force to tax crimes, an essential element of which is willfulness, which this Court has defined as a "voluntary, intentional violation of a *known* legal duty." *United States* v. *Pomponio*, 429 U.S. 10, 12 (1976) (emphasis added). A retroactive re-

* *Accord, Lanzetta* v. *New Jersey*, 306 U.S. 451, 453 (1939); *Conally* v. *General Constr. Co.*, 269 U.S. 385, 391 (1926).

interpretation of the Internal Revenue Code, even if permissible in civil tax cases, may not form the basis for *criminal* liability.

For example, in *James* v. *United States*, 366 U.S. 213 (1961), this Court reversed James' conviction of income tax evasion due to uncertainty in the applicable tax law. James' conviction had been based upon a willful failure to report embezzled funds. Fifteen years before *James*, this Court had held such funds non-taxable. *Commissioner* v. *Wilcox*, 327 U.S. 404 (1946). After *Wilcox* and nine years before *James*, a realigned Court reached a seemingly opposite conclusion, undermining the vitality of *Wilcox* by distinguishing it on tenuous grounds in a case involving extortion income. *Rutkin* v. *United States*, 343 U.S. 130 (1952). The Chief Justice wrote in *James* that as a matter of law, the element of willfulness could not be proved in a criminal prosecution while the law concerning the defendant's conduct was in such a confused state. 366 U.S. at 221-22.

II.

The Decision of the Second Circuit, Which Judged the Issue of Fair Notice Under a Subjective Standard, Is in Conflict With the Decisions of Other Federal Courts of Appeals.

The Second Circuit never disputed that the tax law at issue here was unclear. Rather, it rejected SuCrest's due process challenge to its conviction by stating simply that "[h]ere surely the defendants knew they were committing a wrongful act" (A18). This conclusion is factually in-

correct,* but, more importantly, is legally inapposite under the decisions of this Court, and is in conflict with decisions in other Circuits. The question of fair notice is to be determined objectively; *i.e.*, in regard to "a person of ordinary intelligence", *United States* v. *Harris, supra,* and does not depend upon the subjective expectations of the defendants.

Thus, in *James* v. *United States, supra,* this Court held that the confused state of the tax law precluded James' conviction, notwithstanding the fact that the defendant's "acts were willful and were done in a knowing and conscious attempt to evade and defeat his tax obligations," 366 U.S. at 244 (Harlan, J., concurring in part and dissenting in part), and that there was no evidence in the record that the defendant had actually relied on the prior conflict in the law. *See id.* at 245. *See also United States* v. *Critzer,* 498 F.2d 1160, 1162-64 (4th Cir, 1974) (discussing the facts in *James*).

The reasons for this rule are lucidly set forth in a recent commentary:

> The sole test is whether the government gave the defendant constructive notice that his conduct was prohibited, and gave the criminal justice system a definite standard by which to measure the defendant's guilt. If the uncertain law failed to meet that twofold requirement, *the vagueness doctrine requires acquittal, without regard to the facts of the particular case, including the defendant's state of mind.* The true purpose of

* Testimony in the record of a key Government witness established that "Mr. Rapaport continued to believe that the situation was an appropriate one despite the acknowledgement of the oral agreement." (Tr. 326).

> the vagueness defense is to restrain government, not to ascertain the factual guilt of individual defendants.

Note, *Criminal Liability for Willful Evasion of an Uncertain Tax*, 81 Colum. L. Rev. 1348, 1358-59 (1981) (emphasis added; citation omitted).

In focusing solely on the subjective intent of the individual defendants, the decision of the Court of Appeals for the Second Circuit conflicts with the decisions of the Fourth and Fifth Circuits.* In *United States* v. *Critzer*, 498 F.2d 1160 (4th Cir. 1974), the Fourth Circuit reversed a criminal tax fraud conviction against an Eastern Cherokee Indian who failed to report a portion of her income derived from land held in trust by the United States. Whether the income was taxable was a disputed question dependent on the interpretation of certain land allotment statutes. Said the court:

> As a matter of law, defendant cannot be guilty of willfully evading and defeating income taxes on income, the taxability of which is so uncertain that even coordinate branches of the United States Government plausibly reach directly opposing conclusions. As a matter of law, the requisite intent to evade and defeat income taxes is missing. The obligation to pay is so problematical that *defendant's actual intent is irrelevant.* Even if she consulted the law and sought to

* The Second Circuit relied upon its own decision in *United States* v. *Dixon*, 536 F.2d 1388, 1397 (2d Cir. 1976), which was not a tax case, but rather a criminal prosecution under § 32(a) of the Securities Exchange Act, a statute which does not require "[p]roof of a specific intent to violate the law." *United States* v. *Dixon, supra*, at 1397. In contrast, the instant case involves alleged criminal violations of the Internal Revenue Code, conviction of which "involves a specific intent." *James* v. *United States*, 366 U.S. 213, 221 (1961). *See also* p. 15, *supra*.

> guide herself accordingly, she could have had no certainty as to what the law required.

498 F.2d at 1160 (emphasis added).

Critzer was followed by the Fifth Circuit in *United States* v. *Garber*, 607 F.2d 92 (5th Cir. 1979) (*en banc*), where the court reversed a tax evasion conviction based on the defendant's failure to report income from the sale of her blood plasma. Finding that the taxability of such income had never previously been adjudicated, 607 F.2d at 95, 97, the court held that willfulness had not been proved, and stated that "the relevance of a dispute in the law does not depend on whether the defendant actually knew of the conflict." *Id.* at 97.*

As the court noted, "To hold otherwise would advocate convicting an unsophisticated taxpayer who failed to seek expert advice as to whether certain income was taxable while setting free a wise taxpayer who could find advice that taxes were not due on the identical type of debatably taxable income." *Id.* at 98.

Here, had the defendants actually sought legal advice before undertaking the Rionda transactions, they would have been informed that the sugar purchases from Rionda *could* be included in inventory. Experts in the fields of tax law and inventory accounting so testified in the District Court (Tr. 1874-1900, 1909-22, 2026-42). *See* pp. 8-10, *supra*. The Government's position was not supported by a single case involving LIFO inventories. The report of the

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* In both *Critzer* and *Garber*, the evidence showed that the defendants had subjectively believed that they were violating the tax laws. *See United States* v. *Critzer*, *supra*, 498 F.2d at 1160; *United States* v. *Garber*, *supra*, 607 F.2d at 96 n.3, 101.

law firm of Milbank, Tweed, Hadley & McCloy in 1977 concluded that the propriety of the Rionda transactions was "not free from doubt, and reasonable persons expert in the field of tax law and accountancy may differ in their interpretations and conclusions." (*See* p. 6, *supra*). Even the trial judge agreed that SuCrest's position "might be entirely correct . . . if this were a civil proceeding" (Tr. 1815). Under these circumstances, the conviction of SuCrest violates well-settled standards of due process. As one commentator has written:

> In some cases . . . there are no statutes, regulations or judicial rulings that authoritatively determine the taxability of particular receipts. In those relatively few cases, the defendant can often reasonably claim that the tax evasion statute, including all the tax law it incorporates by reference, is vague as applied. If the defendant can cite prior cases that favor his position and have not been definitively overruled, that alone should demonstrate that the tax law was too vague to support a conviction, even if other cases favor the prosecution. *If, by ordinary analogy and extension from prior authoritative pronouncements the defendant can reasonably argue that his receipts were not taxable, that too would suggest that the law was not clear enough to support a conviction.*

Note, *Criminal Liability for Willful Evasion of an Uncertain Tax,* 81 Colum. L. Rev. 1348, 1363 (1981) (emphasis added).

Conclusion

"Over and over again, courts have said that there is nothing sinister in arranging one's affairs as to keep taxes as low as possible." *Comm'r* v. *Newman*, 159 F.2d 848, 850 (2d Cir. 1947) (L. Hand, J., dissenting).* This Court long ago pointed out that tax avoidance, and even the erroneous underpayment of taxes, are not criminal:

> It is the right as well as the interest of the taxpayer to limit his admission of liability to the amount he actually owes. But the law is complicated, accounting treatment of various items raises problems of great complexity, and innocent errors are numerous . . . it is not the purpose of the law to penalize frank difference of opinion or innocent errors made despite the exercise of reasonable care. Such errors are corrected by the assessment of the deficiency of tax and its collection with interest for the delay.

Spies v. *United States,* 317 U.S. 492, 496 (1943) (Jackson, J.) (footnote omitted).

The decision of the Court of Appeals blurs this crucial distinction between legitimate tax disputes and criminal tax evasion, and thus jeopardizes not only the rights of all taxpayers but also the fair and efficient administration of the federal tax system.

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* *See also Atlantic Coastline R.R.* v. *Phillips,* 332 U.S. 168, 172-73 (1947) (Frankfurter, J.); *Helvering* v. *Gregory,* 69 F.2d 809, 810 (2d Cir. 1934), *aff'd,* 293 U.S. 465, 469 (1928).

For the reasons stated, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 124, 144—August Term, 1982

(Argued October 20, 1982 Decided January 5, 1983)

Docket Nos. 82-1128, 82-1144

UNITED STATES OF AMERICA,

Appellee,

—v.—

INGREDIENT TECHNOLOGY CORPORATION, formerly known as SUCREST CORPORATION, and ROBERT M. RAPAPORT,

Appellants.

Before:

OAKES and WINTER, *Circuit Judges,* and METZNER, *District Judge.**

Appeal by corporation and its former president for tax fraud conviction after jury trial in the United States

* Of the Southern District of New York, sitting by designation.

District Court for the Southern District of New York, Robert L. Carter, Judge, finding that defendants willfully engaged in scheme to overstate "LIFO" inventory through pretended purchase of raw sugar in 1975 and conspired to do so in 1976.

Affirmed.

JULES RITHOLZ, Kostelanetz & Ritholz, New York, N.Y. (Eliot Silverman, David Axelrod, Kostelanetz & Ritholz, New York, N.Y., of counsel), *for Appellant Ingredient Technology Corp.*

FREDERICK T. DAVIS, Patterson, Belknap, Webb & Tyler, New York, N.Y. (Leslie C. Levin, Patterson, Belknap, Webb & Tyler, New York, N.Y., of counsel), *for Appellant Rapaport.*

MINNA SCHRAG, Assistant United States Attorney for the Southern District of New York, (John S. Martin, Jr., United States Attorney for the Southern District of New York, Charles M. Carberry, Warren Neil Eggleston, Walter P. Loughlin, Assistant United States Attorneys for the Southern District of New York, of counsel), *for Appellee.*

OAKES, *Circuit Judge*:

This appeal is by a corporation and its former president from judgments of conviction for tax fraud by means of year-end LIFO ("last-in-first-out") inventory overstatement. The principal arguments of both defendants before the jury in a trial in the United States District Court for the Southern District of New York, Robert L. Carter, Judge, were that the inventory was not overstated because the corporation in fact had legal title on the year-end date to the property in question—raw sugar—even though it had previously agreed to resell it to its seller, and that in any event the element of willfulness was negated because the tax laws were too unclear for the defendants to have known that they had committed a crime. Other arguments based on evidentiary rulings, the court's charge, the statute of limitations, the proof, and a claim that a corporation as a matter of law cannot be convicted of perjury under 26 U.S.C. § 7206(1) are made on appeal. We affirm the convictions.

FACTS

The appellants include Ingredient Technology Corp., which used to be known as SuCrest Corp., and its former president, Robert M. Rapaport. These two were charged in a five-count indictment along with SuCrest's treasurer, Allerton D. Marshall, who was acquitted on all charges. SuCrest and Rapaport were convicted on Count One for conspiracy to evade SuCrest's corporate income tax for fiscal 1975 (18 U.S.C. § 371). Count Two, on which the jury was unable to agree, is irrelevant here. SuCrest and Rapaport were convicted on Count Three for conspiracy to defraud the United States by impeding the Department

of the Treasury in the collection of revenue in connection with SuCrest's federal income tax for fiscal 1976 (18 U.S.C. § 371). SuCrest was convicted on Count Four for its subscribing to a false federal income tax return in fiscal 1975 (26 U.S.C. § 7206(1)); this is the count for which SuCrest claims it cannot be liable as a matter of law. Rapaport was convicted on Count Five for assisting SuCrest in the presentation of a false corporate federal income tax return for fiscal 1975 (26 U.S.C. § 7206(2)).

During 1974 through 1976 SuCrest, a publicly traded company with annual sales in the hundreds of millions of dollars, was principally in the sugar refining and sales business, buying raw sugar for refining from brokers (operators) who either imported raw sugar or bought it from domestic producers. SuCrest had never been in the business of selling raw sugar or buying raw sugar for resale. Rapaport, who was president and chief executive officer of SuCrest, actively participated in the operation of the Sweetener Division which refined and resold refined sugar, and in the tax years in question his approval was required for every purchase of raw sugar. These purchases at any one time involved ten to twenty tons.

In 1974 the price of raw sugar began to fluctuate widely and although SuCrest was making large gross profits as a result of price fluctuations upward, taxes on those profits and the escalating cost of raw sugar depleted its income. Like many other United States sugar refiners, SuCrest switched in 1974 to the LIFO inventory accounting method for its "raw sugar and raw sugar content in goods in process and in finished goods." Under LIFO, of course, the most recently purchased raw materials represent the cost of inventory attributable to costs of goods sold. In this inflationary period, therefore, LIFO pro-

duced a higher cost of goods sold which in turn resulted in lower taxable income than the FIFO (first-in-first-out) method formerly used. Moreover, LIFO more accurately reflected real costs because profits had to be reinvested in increasingly expensive raw materials. Thus in the fiscal year in which SuCrest adopted the LIFO accounting method—1974—it was able to report and to carry forward a loss of about $14.7 million as opposed to a taxable income of $12.2 million which it otherwise would have had to report. This substantial tax saving occurred as a result of large purchases of raw sugar; SuCrest accumulated an unusually large inventory of about 194 million pounds which thereupon constituted what is called the "LIFO base." In SuCrest's case this was valued at about ten cents per pound and, as the accountants insist to those who adopt the LIFO method, it was important to maintain this LIFO base, because if the amount of sugar fell below its level, then an equivalent amount of sugar valued at only ten cents per pound (as opposed to higher subsequent prices) would have to be attributed to that given year's cost of goods sold, with the result that profits and taxes would be increased.

In 1975 and 1976, with both raw sugar prices and interest rates increasing, SuCrest operated its refineries with as little raw sugar on hand to be processed as possible, slightly less than 100 million pounds or about half of the 1974 year-end inventory or LIFO base. Because this would have caused large 1975 profits and taxes, it was determined to add enough raw sugar to the inventory level so as not, in accounting terms, to "invade" the LIFO base before the end of the fiscal year, in this case May 31, 1975. SuCrest could have done so simply by purchasing raw sugar on the open market, but such a

purchase would involve market risks, capital outlay, possibly high interest expenses, and the like. Management set upon another course, resulting in the instant convictions.

The method adopted had the overall effect of involving no financial risk, with title to sugar being taken before the end of the fiscal year but immediately thereafter resold to the seller, with the sugar never entering any flow of raw materials for the refining process, and the only expense being the payment of a small fee to the cooperating operator. More specifically, what was done was the following.

Arrangements were made with one of SuCrest's operators, Czarnikow-Rionda Co. (Rionda), whereby it would sell to SuCrest the quantity of raw sugar SuCrest needed to protect its LIFO base and SuCrest would then sell the raw sugar back to Rionda so that SuCrest would be able to claim formal title without having to take physical delivery and with neither side making a profit on the transaction. In addition, SuCrest and Rionda engaged in an elaborate pricing formula hinged to the market value of raw sugar on the futures exchange because the volatile price fluctuations in the sugar market could result in a resale at a price different from the original purchase price so that either SuCrest or Rionda would stand to lose on what was intended to be simply a bookkeeping transaction. It was agreed that Rionda would sell sugar to SuCrest at 1.075 cents per pound above the July 1975 futures price on the New York Coffee and Sugar Exchange on the day of the sale and buy the sugar back at 1.0 cent above that same futures price on the day of the resale, with the difference of .075 cent going to Rionda as the only SuCrest expense in the transaction. Then SuCrest and Rionda each agreed to take opposite and identical futures positions on the Exchange, which in turn assured

no gain or loss for either party since any gain from the resale of the physical sugar as the result of an increase in sugar price would be matched and offset by an equivalent loss on the futures contracts or vice versa.

SuCrest's contract to purchase 50,000 long tons of raw sugar from Rionda, executed on April 18, 1975, the day SuCrest and Rionda opened their futures positions, was in writing. Rionda's agreement to repurchase was not. Supposedly because of "gossip among sugar buyers," SuCrest brief at 12, Rapaport cautioned one of his juniors not to discuss the details of the Rionda transaction "on the street."

Prior to the close of the SuCrest fiscal year, Rionda in accordance with the purchase contract "declared" to SuCrest title to the cargoes of the two ships Ally and St. Etienne involving 41,755 long tons of raw sugar. It turned out that the remaining 8,245 long tons due under the contract were not required by SuCrest to maintain its LIFO base and they were declared after the end of SuCrest's fiscal year in June 1975. Almost immediately thereafter and while the vessels were still at sea, the same sugar was resold to Rionda. Checks were exchanged for the purchase and resale and for the net changes in the futures positions. SuCrest never actually drew on its funds to pay the nearly $29 million due for the sugar. Rionda made its "commission" of $84,000. Except for satisfying the accountants and the lawyers and ultimately the Government, the transaction was at an end.

Significantly, two facts were not disclosed until a later time. One was that Rionda's vice president, who had entered into the understanding with SuCrest as to the overall transaction, had about a week after April 18 asked for a letter that would set out the terms of the resale, a letter which a SuCrest executive and the Rionda vice

president sealed with wax and placed in the latter's safe. After the transaction was completed, the two men met and destroyed the letter. Significantly also, after Rionda had declared title to the sugar to SuCrest but before the resale, Rionda declared title to the sugar on board the St. Etienne to another customer pursuant to a contract that had been made several weeks earlier. In other words, the transaction was, so far as Rionda was concerned, a total sham. The principal question before the jury was whether, so far as SuCrest and Rapaport were concerned, the transaction was the same.

The company's auditors questioned the subsequent resale despite the fact that there were separate documents for all of the transactions other than the agreement to resell or, on the part of Rionda, repurchase. The auditors in fact obtained an opinion letter from the company's attorneys which stated that, based upon representations received from SuCrest employees that as of the end of the fiscal year SuCrest had no commitment to resell and Rionda no commitment to repurchase the sugar, SuCrest did own the sugar at the end of the fiscal year. The auditors, who were told by Rapaport and Marshall that all data concerning commitments had been made available, that the scope of the auditors' examination had not been restricted, and that "goods for which the company was accountable to others . . . had been excluded from inventories," were left in the dark as to the prearranged agreement of resale. SuCrest accordingly reported cost of goods sold on the basis of the year-end purchase of inventory, thereby understating the SuCrest 1975 operating profit by about $13.7 million.

SuCrest's fiscal year 1976 was also involved. The price of sugar declined after April, 1975, and another similar sale with Rionda was arranged, this time for 60,000 long

tons of raw sugar. The only variations from the preceding year's elaborate arrangements were that SuCrest obligated itself to pay Rionda's commissions for the future trades, covered its own and Rionda's margin requirements, and instead of having a slight variation in the pricing formula was to give Rionda simply a straight $25,000 fee. The fixed differential in the pricing formula, that is to say the figure that was to be added to the price at which July, 1976, futures were trading on the day the raw sugar was purchased and on the day when it was eventually resold, was set at 3.25 cents per pound. The written contract of purchase by SuCrest was dated August 5, 1975, with title not to be declared until May, 1976, and delivery in June or July of 1976. Opposite and identical 1,200-lot futures positions were opened, although they were not shown on reports of open futures positions. In late May, 1976, Rionda declared title to SuCrest to the sugar in three vessels at sea in satisfaction of the August 5, 1975, contract, and during June, 1976, while the vessels were still at sea SuCrest resold the same sugar back to Rionda with the resale prices set according to the formula previously used containing a 3.25-cent fixed differential. The futures positions were mutually reversed, and again each party ended up in exactly the same position as it had been before except for Rionda's obtaining a $25,000 fee and about $74,000 in commissions. The 60,000 long tons of raw sugar were entered on the books and presented to the auditors as such. Meanwhile, however, the raw sugar buyer of SuCrest in the Sweetener Division had told one of the members of the auditing team "off the record" about the resale aspect of the 1976 transaction. False explanations for the resale were given to the auditors in Rapaport's presence by some of his managers, and questioning of a Rionda vice presi-

dent elicited a response that the resale was unrelated to the original purchase by SuCrest. Again, the SuCrest auditors asked counsel for an opinion. Eventually the board of directors was advised by the company vice president who was president of the Sweetener Division that the resale had been prearranged. Audit procedures were expanded. Outside counsel was hired to ascertain the facts and concluded that the Rionda transactions had no substance and that the Rionda sugar purchase should not be included in the 1975 and 1976 computations of costs of goods sold. SuCrest filed its 1976 tax return based upon outside counsel's report and gave no recognition to the Rionda transactions.[1]

DISCUSSION

The primary argument made by both SuCrest and Rapaport is that as a matter of law the Rionda sugar was properly includable in SuCrest's LIFO inventory because SuCrest both had title and bore the risk of loss, satisfying the requirements for inclusion in inventory under the Internal Revenue Code Section 471[2] and Treasury Regulation Section 1.471-1.[3] SuCrest points to the portion of

1 The SEC filed a complaint against the appellants here, Rionda and two other SuCrest executives, each of whom agreed to consent judgments. Rionda also pleaded guilty to two counts of assisting SuCrest in the presentation of false tax return information (26 U.S.C. § 7206(2)).

2 26 U.S.C. § 471 provides:

> Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

3 Treas. Reg. § 1.471-1 provided:

> *Need for Inventories.* In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are

Regulation Section 1.471-1 which requires that "[m]erchandise should be included in the inventory only if title thereto is vested in the taxpayer . . . . although such merchandise is in transit" but should "exclude from inventory goods sold . . . title to which has passed to the purchaser," an event which had not taken place here. *See also* Rev. Rul. 71-451, 1971-2 C.B. 217,[4] Rev. Rul. 81-272, 1981-2 C.B. 116. SuCrest argues that the Treasury Regulation makes "goods under a contract of sale" includable in inventory so long as SuCrest retains title; that SuCrest acquired the sugar "for sale" and not for use in SuCrest's business; and that title to the goods passed

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necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected. (But see § 1.472-1.)

[4] Rev. Rul. 71-451 involved a contract of sale or return used by a garden seed producer, which did not treat seeds delivered to dealers under such a contract as sales. Following *J.J. Little and Avis Co. v. Commissioner*, T.C. Memo 1966-68, the Service ruled that income accrued to the producer when title passed, i.e., on delivery to a common carrier, and that seeds so delivered could not be included in inventory. In that situation neither party knew what portion, if any, of the seeds would be returned, whereas here both parties knew that all the raw sugar would be returned. There the business purpose of the contract of sale or return was to give the dealers an inventory for resale to customers. Here there was no way in which SuCrest was to use the Rionda sugar.

under New York Uniform Commercial Code Sections 2-401, 2-501, which in turn is said to have passed the risk of loss to SuCrest. *Id.* § 2-509. Thus, even if the oral understanding between SuCrest and Rionda amounted to a contract of resale, the argument runs, SuCrest could still include the sugar in its inventory. Moreover, it is said, the oral resale agreement involved the sale of goods in excess of $500 which was not an enforceable contract because it was not in writing as it must be under the New York Statute of Frauds. *Id.* § 2-201(1). It is also contended that the unsigned letter in the Rionda safe was not enforceable by SuCrest or Rionda because the executive who signed the letter on behalf of SuCrest never was authorized to do so. Support for this last point is said to lie in Rev. Rul. 71-451, 1971-2 C.B. 217, *see supra* note 4, and cases to the effect that it is immaterial that SuCrest may have intended to resell the sugar before it actually did sell. The hedging transaction was said to be a normal hedge which does not make for inventory ineligibility. *Monfort of Colorado, Inc. v. United States*, 561 F.2d 190 (10th Cir. 1977); Rev. Rul. 74-226, 1974-1 C.B. 119;[5] Rev. Rul. 74-223, 1974-1 C.B. 23.[6] SuCrest made an elaborate argument to the jury and argues to us that because the futures prices involved cover only the cost of the raw sugar and not the cost of insurance and freight, that is to

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5 Rev. Rul. 74-226 dealt with commodities dealers on organized exchanges who are required to maintain inventories, and ruled that they are entitled to value goods on hand at market value when engaged in "carrying operations" or "straddles." There the purchase or sale of commodities was an income-producing factor.

6 Rev. Rul. 74-223 also dealt with commodities dealers and ruled that they may take into account gains or losses based upon the market value of such open futures contracts to which they are parties as are hedges against actual spot or cash transactions or against "forward" sales or purchases, but not of purely speculative transactions not offset by such transactions or such sales and purchases.

say, are on an FOB basis, whereas the price for a purchase of actual sugar is CIF, i.e., includes the cost of insurance and freight, the difference, that cost, amounts to the "CIF differential" which, of course, is also subject to a certain amount of market fluctuation. The theory presented is that the elaborate purchase of opposite and identical futures was so as to hedge the CIF differential which was not hedgable merely by going short on the futures contract.

Having satisfied the formal requirements of what it sees as the applicable rules, SuCrest urges us to understand its elaborate machinations as a legitimate ploy to hold down taxes and directs us to the maxim that a person is entitled to arrange his taxes so as to pay only that which is due. But, of course, the taxpayer is not permitted to avoid taxes which *are* due and the invocation of the phrase tells us nothing about what must ultimately be rendered unto the I.R.S. any more than Socrates solved the thorny problems of justice by defining it to require that we give every person his due. *See* P. Westen, "The Empty Idea of Equality," 95 Harv. L. Rev. 537, 556-58 (1982). At best such maxims, which Roscoe Pound labeled "minims" because they revealed so little, *Sheppard v. United States*, 361 F.2d 972, 977 n.9 (6th Cir. 1966), are "singularly unhelpful when it comes to deciding cases," *Goldstein v. Commissioner*, 364 F.2d 734, 741 n.7 (2d Cir. 1966). As a starting point, they are at best confusing. *See, e.g., Grove v. Commissioner*, 490 F.2d 241 (2d Cir. 1973). *See generally Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Gregory v. Helvering*, 293 U.S. 465, 470 (1935).

These conclusory maxims are less confusing if we regard them *as* conclusions for substantive analysis and the substance underlying the transaction is taken to be the

start. Two factors guide us here. First, we agree with Judge Learned Hand in dissent in *Gilbert v. Commissioner*, 248 F.2d 399, 412 (2d Cir. 1957), that it is immaterial whether we are talking about "substantial economic reality," "substance over form," "sham" transactions, or the like; rather the question is whether under the statute and regulations here involved the transaction affects a beneficial interest other than the reduction of taxes. And here we note that the very first sentence of Section 1.471-1 makes inventories necessary in the first instance "in every case in which the production, purchase, or sale of merchandise is an *income-producing factor*." (Emphasis added.) Thus, while title may be necessary for inclusion in inventory, it in itself is not alone sufficient, at least where the parties' purpose is solely tax avoidance. *See United States v. Balanovski*, 236 F.2d 298, 306 (2d Cir. 1956), *cert. denied*, 352 U.S. 968 (1957). Here, from the beginning, it was never intended that the sugar which was on board ship would be for SuCrest "an income-producing factor." On the contrary, it was never intended to be refined, and SuCrest was not in the business of selling or brokering raw sugar. SuCrest would have us give meaning to inventory which was never intended to be used or sold in the regular course of business. In fact, the transaction was designed *not* to earn money for SuCrest. Irrespective of legal enforceability of the contract of resale, whether under Restatement Section 90 or otherwise, the fact that Rionda was one of SuCrest's regular operators and was paid in effect a commission indicates that Rionda had a business interest in going through with the 1975 transaction, a business interest which was further demonstrated by its willingness to go through the same charade in 1976. There was absolutely no beneficial interest on the part of SuCrest except to inflate inventory for a few days

solely for tax purposes, and there was no prospect of gain from the transaction; indeed it was sure to lose in terms of brokerage commissions and Rionda's fee for engaging in it, however depicted to SuCrest. The fact that Rionda's obligation to repurchase may have been unenforceable, however it may be examined, does not affect SuCrest's purpose to avoid taxes which would have occurred irrespective of such enforceability; the only thing that lack of enforceability shows, if indeed there were such, is that the scheme might not have succeeded in its true goal of losing money only to the extent of the brokerage commissions and fee to Rionda. This "beneficial interest factor" alone should be sufficient in this case to disqualify SuCrest's purchase from its LIFO base.

Second, as *Corliss v. Bowers*, 281 U.S. 376, 378 (1930), stated broadly, "taxation is not so much concerned with the refinements of title as it is with *actual command* over the property taxed." (Emphasis added.) SuCrest argues that as of the end of the fiscal year it had title to the sugar and therefore enjoyed the right "to take possession of the sugar, to refine it, or to sell it," and suffered the hazard that "if the ships had sunk, or if the sugar had become so damaged as to become unmarketable, SuCrest would have had to bear the risk of economic and physical loss." Brief at 31. This, of course, assumes that Rionda was not in fact in control of the sugar. On this score, Rionda had none of the illusions that SuCrest urges us to abide here: Rionda declared title to the sugar to third parties even before the sugar was sold back by SuCrest. It is only on the issue of actual control of the property that SuCrest's argument that its contract with Rionda was unenforceable has any significance. At the outset, we note that "[t]ax consequences follow what has taken place, not what might have taken place," *Central Tablet Manufacturing*

Co. v. United States, 417 U.S. 673, 690 (1974), and the resale agreement was completely obeyed here. Second, it would be high irony to find that the defendants here are immune to prosecution for their scheme because they never wrote it down. The reason it was never written down, and the reason that the copy sealed in wax was destroyed, is that such a document would prove that they had agreed to resell at the time of sale and would close the case against them in a prosecution like this one. In short, the contract was never written because it was illegal, and we decline the defendants' invitations to apply the Statute of Frauds not as a measure to protect the parties to contracts but as a means to promote frauds on the government.[7]

We conclude that the concept of inventory from an accounting point of view and the term inventory in the applicable Treasury Regulations would be meaningless were there to be included in the term or concept property bought, agreed to be resold, never intended to be utilized in the trade or business of the taxpayer (except for tax purposes), and in fact under the corporate taxpayer's dominion, control, and at itw risk about as long as the pea in the proverbial shell game is under the shell.

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[7] We also duly note the nice distinction made in the SuCrest brief at 34 and n.* between unenforceable oral resale agreements such as were disregarded by the Court of Claims in a case involving the issue whether a bank holding municipal bonds as collateral for a bond dealer's loan was subject to the tax exemption for interest on municipal securities, *Citizens National Bank v. United States*, 551 F.2d 832, 841 (Ct. Cl. 1977), and cases involving a similar issue involving written and enforceable resale agreements, e.g., *Union Planters National Bank v. United States*, 426 F.2d 115 (6th Cir. 1970) (burden did not assume risk of fluctuations in market value of bonds). The appellants would like to have us apply a similar distinction here, even though the issue before us relates to the entirely distinguishable category of inventories and not to the deductibility of interest on bonds held as collateral.

The next argument, which is on due process grounds but also goes to the court's exclusion of proffered expert testimony and refusal to instruct the jury, is that the convictions must be reversed because the applicable tax law was at least in such dispute that it was not sufficiently clear at the time of the Rionda transactions to provide a "clear and definite statement of the conduct proscribed" under *United States v. Chiarella*, 588 F.2d 1358, 1377 (2d Cir. 1978) (dissenting opinion), *rev'd*, 445 U.S. 222 (1980), thereby negating the element of willfulness or scienter.[8]

We agree that a criminal statute must meet the requirements of the Due Process Clause and be sufficiently definite as to "give a person of ordinary intelligence fair notice that his contemplated conduct is forbidden." *United States v. Harris*, 347 U.S. 612, 617 (1954). *See also Bouie v. City of Columbia*, 378 U.S. 347, 352 (1964). But as this court has noted,

> All the Due Process clause requires is that the law give sufficient warnings that men may conduct them-

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[8] SuCrest and Rapaport concede that in 1979 the Internal Revenue Service issued Rev. Rul. 79-188, 1979-1 C.B. 191, which took the position that property not intended by the taxpayer to be used in business could not be included in inventory to avoid invasion of a LIFO base. But it is argued that the very fact that the Service issued this ruling proves that the question was not settled in 1975. The issuance of the LIFO Revenue Ruling in 1979 on which the appellants rely by no means signifies a lack of clarity in the law at the time the SuCrest-Rionda transaction was entered into in 1975. In the first place, the ruling goes to different facts, since under it the purchase and resale were not prearranged, the prices were not structured to eliminate the possibility of profit or loss on the resale, and there were no indicia of concealment. Moreover, as Revenue Ruling 79-188 itself points out, "the purpose for which raw material is purchased is a major factor whether such material is inventoriable by the taxpayer," and has been since *Latimer-Looney Chevrolet, Inc. v. Commissioner*, 19 T.C. 120 (1952) *acq'd in* 1953-1 C.B. 5, which the Ruling cites for that proposition.

> selves so as to avoid that which is forbidden, and thus not lull the potential defendant into a false sense of security, giving him no reason even to suspect that his conduct might be within its scope.

United States v. Herrara, 584 F.2d 1137, 1149 (2d Cir. 1978). And of course it is immaterial that "there is no litigated fact pattern precisely in point." *United States v. Brown*, 555 F.2d 336, 339-40 (2d Cir. 1977). Here surely the defendants knew they were committing a wrongful act. *United States v. Dixon*, 536 F.2d 1388, 1397 (2d Cir. 1976). The resale component of the agreement was concealed. The auditors were lied to, as were the attorneys. The secret letter sealed with wax was hidden in a safe and then destroyed. *Cf. United States v. Feola*, 420 U.S. 671, 685 (1975) (conviction for assaulting federal officer upheld despite defendant's ignorance of victim's official identity). Willful intent was a question of fact decided by the jury at trial contrary to the defendants. *United States v. Pomponio*, 563 F.2d 659, 662 (4th Cir. 1977), *cert. denied*, 435 U.S. 942 (1978).

The more sophisticated argument is made that the district court's exclusion of the testimony offered by two of defendant's experts, coupled with the decision of the trial court not to instruct the jury in terms of Treasury Regulation § 1.471-1, thwarted the defense that the defendants could not have formed a willful intent. Rapaport argues that the clarity of whatever legal duty was owed has become, in this case, an issue of fact and not of law. The defendants point to *United States v. Garber*, 607 F.2d 92 (5th Cir. 1979) (en banc), a case involving a prosecution for tax evasion for having failed to report income from the sale of the taxpayer's blood containing a rare and valuable antibody, where the Fifth Circuit held

exclusion of the testimony of a tax expert that in his opinion the income was not taxable was erroneous and reversed the conviction. Indeed, it is pointed out, the Fifth Circuit went further to say that the relevance of a dispute in the law "does not depend on whether the defendant actually knew of the conflict." *Id.* at 98, citing *United States v. Critzer*, 498 F.2d 1160 (4th Cir. 1974). *See also United States v. Clardy*, 612 F.2d 1139, 1153 (9th Cir. 1980) (government expert's testimony relative to issue of willfulness admissible where defense theory is that there is good faith dispute as to tax law interpretation). We decline to apply the *Garber* reasoning for two reasons. First, the holding of that case was that in view of the defense that Ms. Garber "subjectively thought that proceeds from the sale of part of her body were not taxable" exclusion of an accountant's expert testimony that money obtained from the sale of blood plasma was not taxable income was reversible error. Here, however, there was no evidence that Rapaport or anyone else at SuCrest genuinely thought that what they were doing was lawful and proper; on the contrary, their conduct indicated a subjective belief in the *un*lawfulness of the conduct. Second, as pointed out in Note, *Criminal Liability for Willful Evasion of an Uncertain Tax*, 81 Colum. L. Rev. 1348, 1360 (1981), the *Garber* majority's approach permits juries to find that uncertainty in the law negates willfulness whether or not the defendants are actually confused about the extent of their tax liability. In contrast, prior cases on willfulness consistently require factual evidence of the defendants' state of mind to negate willfulness under any theory. *See id.* at 1357. We agree with the *Garber* dissent, 607 F.2d at 105, that it would be very confusing to a jury to have opposing opinions of law admitted into evidence as involving a factual question for

them to decide. Indeed, as that dissent points out, the inevitable logic of the majority's decision in *Garber* is that if the tax law is uncertain, the indictment should be dismissed. Questions of law are for the court. *United States v. Bronston*, 658 F.2d 920, 930 (2d Cir. 1981), *cert. denied*, 102 S.Ct. 1769 (1982); *Marx & Co. v. Diners Club, Inc.*, 550 F.2d 505, 509-10 (2d Cir.), *cert. denied*, 434 U.S. 861 (1977). *See also* 7 Wigmore, *Evidence* § 1952 at 81. To the extent that *Garber* is inconsistent with our *Bronston* and *Marx* cases, we decline to follow it. We note that the Fifth Circuit has itself limited *Garber* in *United States v. Herzog*, 632 F.2d 469, 473 (5th Cir. 1980) (expert's view of tax laws irrelevant to willfulness issues since complexity of laws sheds no light on defendant's intent).

The court's instructions were proper concerning willfulness, an issue which is a question of fact to be determined by the jury. *Spies v. United States*, 317 U.S. 492, 500 (1943). The instructions as set forth in the margin[9] gave,

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[9] I instruct you that a transaction without economic substance which is entered into solely for the purpose of tax avoidance can't properly be used to compute taxes. The government contends that an agreement simultaneously to purchase and resell the same amount of raw sugar on terms that guarantee no risk of loss or chance for gain has no economic significance.

A taxpayer may of course try to pay as little tax as possible so long as he uses legal means. Transactions may be arranged in an attempt to minimize taxes if the transactions have economic substance. The defendants contend that the Rionda transaction had economic substance. They claim that SuCrest had title to the sugar purchased from Rionda, had risk of loss with respect to such sugar, had a binding obligation to resell the sugar at a fixed price and had a business purpose in entering into the Rionda transaction.

As a final instruction on this count, I will discuss certain terms you have heard used throughout the trial:

Inventories are defined by the Internal Revenue Code as raw material acquired for sale or manufacture in the ordinary course of business.

in our opinion, all that is necessary: a fair presentation of the defense's contentions. *United States v. Park*, 421 U.S. 658, 674-75 (1975). Instructions given in the precise terms of the Treasury Regulation would invite the jury to interpret the law which is, as we have said, a matter for the judge. *See United States v. Lanni*, 466 F.2d 1102, 1110 (3d Cir. 1972).

The remaining arguments of appellants are no more persuasive. They contend that in connection with the 1976 tax return no conspiracy to defraud was alleged because the transactions were not reflected in SuCrest's 1976 tax return and no such conspiracy was accordingly established. They rely on the decision in *United States v. Tarnopol*, 561 F.2d 466, 474 (3d Cir. 1977), that the mere keeping of false books and records does not amount to a conspiracy to defraud the United States in connection with the collection of revenue under 18 U.S.C. § 371. A specific statute dealing with revenue matters was construed as early as *Haas v. Henkel*, 216 U.S. 462, 479

Inventories, as so defined, must be recorded on tax returns so as to clearly reflect income.

The government contends that the raw sugar involved in the Rionda transaction was not acquired for use in the ordinary course of SuCrest's business and that the sugar was thus not truly part of SuCrest's inventory.

. . . .

I told you that the defendants contended that SuCrest had title to the sugar purchased, that the Rionda transaction had economic [substance], that the title to the sugar purchased from Rionda had risk of loss with respect to the sugar and that the transaction had a business purpose.

I misstated. What I should have also told you is that they contend that the oral agreement to resell the sugar to Rionda was not binding on either Rionda or on SuCrest. That is the defendant's contention.

(1910), to apply in the case of a corrupt agreement "calculated to obstruct or impair" the given governmental department's function. A conspiracy is, after all, an agreement to engage in prohibited conduct. *United States v. Herrara, supra*, 584 F.2d at 1150. It is immaterial that conspirators disband or are interrupted before the goal is achieved. *See United States v. Rosner*, 485 F.2d 1213, 1228-29 (2d Cir. 1973), *cert. denied*, 417 U.S. 950 (1974); W. Lafave & A. Scott, *Criminal Law* 459 (1972). Recognizing that conspiracy-to-defraud prosecutions must be carefully scrutinized, *United States v. Rosenblatt*, 554 F.2d 36, 40 (2d Cir. 1977), here the indictment and proof withstand such scrutiny since the criminal agreement was sufficiently established. *United States v. Tarnopol, supra*, is distinguishable, because there the Government failed to prove that the conspirators intended to defraud the Internal Revenue Service, even though they had not kept accurate business records. Here the whole purpose of the sale and resale transaction in 1976 as well as in 1975 was to evade federal taxes. As for the argument that a taxpayer has a right of "self-correction," it is clearly inapplicable to these defendants since it was only when the fraud was detected by the auditors that the scheme was dropped. *See United States v. James*, 609 F.2d 36, 41-42 (2d Cir. 1979), *cert. denied*, 445 U.S. 905 (1980). Requested instructions to this effect were therefore properly disallowed. In other words, Rapaport and his company did not go through with the ultimate fraud not because they "saw the light," but because the light saw them.

Appellants do have support, in connection with the Count Three charge of conspiracy to defraud in 1976, for their claim that the applicable statute of limitations is five

rather than six years, and that 18 U.S.C. § 3282, the general five-year statute, is applicable rather than that portion of 26 U.S.C. § 6531(1), (8).[10] While 26 U.S.C. § 6531(8) expressly refers to 18 U.S.C. § 371, "where the object of the conspiracy is to attempt in any manner to evade or defeat any tax or the payment thereof," the argument is that this is not an offense "arising under" the Internal Revenue laws. Moreover, support is said to lie for the applicability of section 3282 in *Grunewald v. United States*, 353 U.S. 391, 396 & n.8 (1957); *United States v. Klein*, 247 F.2d 908 (2d Cir. 1957), *cert. denied*, 355 U.S. 924 (1958); and *United States v. Witt*, 215 F.2d 580 (2d Cir.), *cert. denied*, 348 U.S. 887 (1954). Each of these cases states that an indictment alleging conspiracy under section 371 is governed by the statute of limitations set forth in 18 U.S.C. § 3282. We agree, however, with *United States v. Lowder*, 492 F.2d 953, 955-56 (4th Cir.), *cert. denied*, 419 U.S. 1092 (1974), that it was simply pure oversight in *Grunewald*, *Klein*, and *Witt* that reference was not made to the six-year statute, § 6531(1)(8). *See also United States v. Fruehauf Corp.*, 577 F.2d 1038, 1070

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[10] 26 U.S.C. § 6531 provides in part:

> No person shall be prosecuted . . . for any of the various offenses arising under the internal revenue laws unless the indictment is found or the information instituted within 3 years next after the commission of the offense, except that the period of limitations shall be 6 years—
>
> (1) For offenses involving defrauding or attempting to defraud the United States or any agency thereof, whether by conspiracy or not and in any manner;
>
> . . . .
>
> (8) for offenses arising under Section 371 of Title 18 of the United States Code, where the object of the conspiracy is to attempt in any manner to evade or defeat any tax or the payment thereof.

1070 (6th Cir.), *cert. denied*, 439 U.S. 953 (1978). The error is understandable because section 3282 applies "[e]xcept as otherwise expressly provided by law," but the statute does not name the exceptive statutes and leaves the courts to search the United States Code for them, a search which did not lead to section 6531 in *Grunewald*, *Klein*, or *Witt*. In this respect this opinion has been circulated before filing to the active judges in this circuit, who have expressed no desire to hear the matter en banc.

SuCrest argues that its conviction on Count Four must be reversed because as a matter of law a corporation cannot be guilty of false declaration under 26 U.S.C. § 7206(1).[11] That section is described as a perjury statute and we are referred to the line of authority holding that corporations cannot commit perjury since a corporation cannot take an oath to tell the truth. *See* Note, 60 Harv. L. Rev. 283, 284 (1946); *United States v. John Kelso Co.*, 86 F. 304, 306 (N.D. Cal. 1898). And it is said that the Service has itself interpreted § 7206(1) and its predecessor, § 3809(A) of the Internal Revenue Code of 1939, so as not to apply to corporations, an interpretation which, while not controlling, is entitled to considerable weight. *E.g.*, *United States v. National Association of Security*

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[11] 26 U.S.C. § 7206(1) provides:

> Any person who—
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> . . . [w]illfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter[,]
>
> . . .
>
> shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $5,000, or imprisoned not more than 3 years, or both, together with the costs of prosecution.

Dealers, Inc., 422 U.S. 694, 719 (1975). But "person" is defined in the Internal Revenue Code to refer to corporations, 26 U.S.C. § 7701(A)(1), and § 7206(1) refers to "[a]ny person" willfully making and subscribing any return or other document verified by a written declaration that it is made under the penalties of perjury. Moreover, in terms of the statutory history the 1939 Code § 52 provided that "[e]very corporation subject to taxation under this Chapter shall *make* a return" to be sworn to by a principal executive and a principal financial officer. (Emphasis added.) Individuals were by the Revenue Act of 1942 § 145(C) made subject to perjury penalties for willfully making and subscribing false returns and the 1949 amendments to the Code adding § 3809(A) covered any person, a term including trusts, estates, partnerships, associations, companies, and corporations. *See* Sections 1426(f), 1532(i), 1607(k), 1805, 1931(b), 2733(i), 3228(2), 3238(a), 3797(a)(i) (1939), now collected in 26 U.S.C. § 7701(A). While a corporation has no independent state of mind, the acts of individuals on its behalf may be properly chargeable to it. *See United States v. Demauro*, 581 F.2d 50, 53 (2d Cir. 1978); *J.C.B. Super Markets, Inc. United States*, 530 F.2d 1119 (2d Cir. 1976). Other circuits have agreed under other analogous statutes. *United States v. Lange*, 528 F.2d 1280 (5th Cir. 1976) (18 U.S.C. § 1001); *United States v. Milton Marks Corp.*, 240 F.2d 838 (3d Cir. 1957) (18 U.S.C. § 287). Moreover, the Internal Revenue Service has in fact prosecuted other corporations for violations of § 7206(1). *See, e.g., United States v. Minnesota Mining & Manufacturing Co.*, 428 F. Supp. 707 (D. Minn. 1976) (indictment dismissed on other grounds), *aff'd*, 551 F.2d 1106 (8th Cir. 1977).

We have examined the other contentions of the appellants and find them without merit.[12]

Judgment affirmed.

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[12] First, Rapaport's argument that his cross examination of witnesses was unfairly limited at best applies to the attempted re-cross of the witness Azarow who had been cross-examined for what amounts to 170 pages of final transript. Moreover, Judge Carter aptly noted that the pedantic concerns of counsel on re-cross were designed "to confuse and not clarify." Second, Rapaport's only tenable argument against the admission of SuCrest's 10-K Reports to the Securities and Exchange Commission is that it might have been misunderstood to apply to Rapaport as well as to SuCrest, an allegation mitigated by the court's repeated instruction to the jurors that these statements did not apply to Rapaport. Third, the government introduced evidence that SuCrest had not even recorded the receipt of the Rionda sugar in its files, but the records introduced covered two weeks and not the week that intervened between them. The prosecution explained the missing week by noting to the jury, after the defense was given an opportunity to introduce a witness or submit a reason for the failure of the records to cover the relevant week, that the files contained no report for the intervening week. The statement would by no means necessarily lead the jury to believe that the "defendants had suppressed or otherwise despoiled potentially critical evidence," and any risk that this would happen could have been cured by SuCrest through testimony or suggested explanations to be included in the prosecutor's statement. Finally, Judge Carter's instruction cautioning the jury that Rapaport's failure to testify could not be used to infer his guilt substantially mirrored the one approved by this court in *United States v. Lopez*, 584 F.2d 1175, 1179 (2d Cir. 1978), and we decline to disapprove it here.

18 U.S.C. § 371

§ 371. Conspiracy to commit offense or to defraud United States

If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than $10,000 or imprisoned not more than five years, or both.

If, however, the offense, the commission of which is the object of the conspiracy, is a misdemeanor only, the punishment for such conspiracy shall not exceed the maximum punishment provided for such misdemeanor.

26 U.S.C. § 7201

§ 7201. Attempt to evade or defeat tax

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.

26 U.S.C. § 7206

§ 7206. Fraud and false statements

Any person who—

(1) Declaration under penalties of perjury.—Willfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter; or

(2) Aid or assistance.—Willfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim or document; or

(3) Fraudulent bonds, permits, and entries.—Simulates or falsely or fraudulently executes or signs any bond, permit, entry, or other document required by the provisions of the internal revenue laws or by any regulation made in pursuance thereof, or procures the same to be falsely or fraudulently executed, or advises, aids in, or connives at such execution thereof; or

(4) Removal or concealment with intent to defraud.—Removes, deposits, or conceals, or is concerned in removing, depositing, or concealing, any goods or commodities for or in respect whereof any tax is or shall be imposed, or any property upon which levy is authorized by section 6331, with intent to evade or defeat the assessment or collection of any tax imposed by this title; or

(5) Compromises and closing agreements.—In connection with any compromise under section 7122, or offer of such compromise, or in connection with any closing agreement under section 7121, or offer to enter into any such agreement, willfully—

(A) Concealment of property.—Conceals from any officer or employee of the United States any property belonging to the estate of a taxpayer or other persion liable in respect of the tax, or

(B) Withholding, falisifying and destroying records.—Receives, withholds, destroys, mutilates, or falsifies any book, document, or record, or makes any false statement, relating to the estate or financial condition of the taxpayer or other person liable in respect of the tax;

shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $5,000, or imprisoned not more than 3 years, or both, together with the costs of prosecution.

26 U.S.C. § 471

§ 471. General rule for inventories

Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

26 U.S.C. § 472

§ 472. Last-in, first-out inventories

(a) **Authorization.**—A taxpayer may use the method provided in subsection (b) (whether or not such method has been prescribed under section 471) in inventorying goods specified in an application to use such method filed at such time and in such manner as the Secretary may prescribe. The change to, and the use of, such method shall be in accordance with such regulations as the Secretary may prescribe as necessary in order that the use of such method may clearly reflect income.

(b) **Method applicable.**—In inventorying goods specified in the application described in subsection (a), the taxpayer shall:

(1) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof; and second, those acquired in the taxable year;

(2) Inventory them at cost; and

(3) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method.

(c) **Condition.**—Subsection (a) shall apply only if the taxpayer establishes to the satisfaction of the Secretary that the taxpayer has used no procedure other than that specified in paragraphs (1) and (3) of subsection (b) in inventorying such goods to ascertain the income, profit, or loss of the first taxable year for which the method described in subsection (b) is to be used, for the purpose of a report or statement covering such taxable year—

(1) to shareholders, partners, or other proprietors, or to beneficiaries, or

(2) for credit purposes.

(d) **Preceding closing inventory.**—In determining income for the taxable year preceding the taxable year for which the method described in subsection (b) is first used, the closing inventory of such preceding year of the goods specified in the application referred to in subsection (a) shall be at cost.

(e) **Subsequent inventories.**—If a taxpayer, having complied with subsection (a), uses the method described in subsection (b) for any taxable year, then such method shall be used in all subsequent taxable years unless—

(1) with the approval of the Secretary a change to a different method is authorized; or,

(2) the Secretary determines that the taxpayer has used for any such subsequent taxable year some procedure other than that specified in paragraph (1) of subsection (b) in inventorying the goods specified in the application to ascertain the income, profit, or loss of such subsequent taxable year for the purpose of a report or statement covering such taxable year (A) to shareholders, partners, or other proprietors, or beneficiaries, or (B) for credit purposes; and requires a change to a method different from that prescribed in subsection (b) beginning with such subsequent taxable year or any taxable year thereafter.

If paragraph (1) or (2) of this subsection applies, the change to, and the use of, the different method shall be in accordance with such regulations as the Secretary may prescribe as necessary in order that the use of such method may clearly reflect income.

26 C.F.R. § 1.471-1

§ 1.471-1 Need for Inventories

In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected. (But see § 1.472-1.)